Internal Revenue Service

memorandum

CC:TL-N-10523-87
Brl:JCAlbro

date: OCT 16 1987

to: District Counsel, San Francisco CC:SF
Attn: Margaret Rigg

from: Director, Tax Litigation Division CC:TL

subject: [redacted]

This is in response to your request for technical advice dated August 28, 1987, concerning the above-mentioned case.

ISSUE

Whether the Service should oppose petitioner's Motion to Dismiss for Lack of Jurisdiction which states that [redacted], was a TEFRA partnership in [redacted] and that the statutory notice of deficiency for [redacted] issued to taxpayer, a partner in [redacted], is invalid. RIRA Nos. 6221.00-00; 6225.00-00; 6229.00-00.

CONCLUSION

We agree with your conclusion that the petitioner is correct in asserting that the statutory notice of deficiency is invalid and that the Service should not oppose the motion to dismiss. We believe the facts indicate that the partnership was formed subsequent to the TEFRA effective date of September 3, 1982. The documents indicate an intent for the offering to close and the partnership to be formed by [redacted] and apparently the partnership asset was acquired on [redacted]. Even assuming that formation did not occur until [redacted] when the [redacted]th and final partnership unit was sold, the fact that the partnership filed a [redacted] return subjects it to the TEFRA partnership audit and litigation provisions pursuant to section 6233(a) for taxable year [redacted].

FACTS

[redacted], a [redacted] member limited partnership, was formed to purchase and commercially exploit a musical television special. The general partner is [redacted]. The private placement memorandum is dated [redacted] and offers [redacted] limited partnership interests at $[redacted] per unit for a total of $[redacted]. The offering states it will terminate at the earlier of the date on which all interests offered are purchased or [redacted], provided that the general partner may extend the offering. (p.4). At page 7 the offering states that it is anticipated that investors purchasing interests will realize [redacted] tax deductions. It also states that the partnership will only be funded upon the receipt and acceptance by the general partner of subscriptions for all [redacted] interests, and subscription proceeds will be deposited in an escrow bank account. If subscriptions for all interests have not been received or accepted on or before [redacted] (sic) unless extended by the general partner, the offering will terminate and all funds will be returned with interest. At page 26 it states that the general partner may release funds from the partnership account, and if the offering terminates as provided, the general partner is liable to investors for funds released. The proceeds of the offering are anticipated to be applied on the purchase date as shown on p.29 under "use of the proceeds". The use of proceeds shows the breakdown of the $[redacted] total subscription amount with $[redacted] applied to a downpayment on the special. With respect to the special, the offering states (p.21) that the special will be acquired when [redacted] partnership interests have been sold, and on the purchase date the cash portion of the price ($[redacted]) will be paid. The partnership and seller will also enter into the Acquisition Agreement for purchase and sale of the special, and the contemplated purchase date will occur within 75 days of [redacted] ([redacted].

The subscription agreement provides that if all [redacted] interests are not subscribed within 75 days of the date of the placement memorandum ([redacted]) the offering may be terminated unless the general partner extends the offering. If less than [redacted] interests are sold, the general partner shall terminate the offering and return all subscription funds. The first partnership interest was sold on [redacted]; [redacted] interests had been sold by [redacted], and all [redacted] interests were sold by [redacted].

The one partnership agreement available is undated, and it does not indicate the parties'intent on formation date of the partnership. There are three Certificates of Limited Partnership in evidence. The Certificates state that the partnership's term shall be from the effective date of the certificate. Certificate I is dated [redacted], states an effective date of [redacted] and was recorded on [redacted]. The certificate shows two partners, [redacted] with a $[redacted] investment and [redacted], a dummy partner with a $[redacted] investment. Certificate II is dated [redacted], does not show an effective date and apparently was not recorded. Certificate III is an Amended Certificate which is dated [redacted] and states that it is effective [redacted]. It was signed [redacted] by [redacted] for himself and [redacted] limited partners and recorded on [redacted].

A checking and a savings account were opened on [redacted], and bank statements show that $[redacted] was deposited by [redacted]. A distribution agreement for the special, dated [redacted] was entered into by general partner, [redacted] as the "owner" which implies that the partnership was not formed yet. The Bill of Sale for the special to [redacted] is effective [redacted] and refers to the Acquisition Agreement as "executed concurrently". The Acquisition Agreement is dated [redacted] and is signed for [redacted] by general partner, [redacted] Paragraph 5(A) states that $[redacted] was paid concurrently and receipt is acknowledged.

We understand that the Appeals Officer strongly urges that we raise an estoppel argument in opposition to the taxpayer's motion. The relevant facts are that the partnership Form 1065 for taxable year [redacted] stated that business started on [redacted], (Item E), and that the partnership was actively operated for 6 months in [redacted] (Item N). Furthermore, the partnership claimed certain deductions and credits including amortization of start-up costs and depreciation, as though it was in existence and doing business on [redacted]. Finally, there is the general partner's response to the examiner's question in Information Document Request 3; "Why was the the tax year stated as beginning on [redacted] when the partnership activity appears to have begun [redacted]?" The general partner answered:

> There was a substantial amount of work to start the partnership and to begin the process to acquire the film tapes before starting to sell the Limited Partnership Units. This process was started in early [redacted]. The first original filing was in early [redacted]. The production of the film was completed in late [redacted]. Meetings with prospective investors were held in October and November.

DISCUSSION

As part of the Tax Equity and Fiscal Responsibility Act (TEFRA), Congress enacted I.R.C. §§ 6221 through 6231, which provide for unified administrative and judicial proceedings at the partnership level. These partnership audit provisions are generally applicable to partnership taxable years beginning after September 3, 1982.

We realize that examiners have made the TEFRA/non-TEFRA determination solely by relying upon the information contained on the partnership return, namely, Item E, date business started, and Item N, the number of months in 1982 that the partnership was actively operated. Apparently this has been done based upon a misplaced reliance on an estoppel theory, i.e., since the partnership supplied the information on the return it should be precluded from contending that it is a TEFRA partnership.

It is our position that the formation date rather than the date business started, should be controlling with respect to when a partnership's taxable year began, and that it is not sufficient to simply rely on Item E and Item N.

The primary criterion for determining the formation date is either the date of filing of the Certificate of Limited Partnership with the designated state authority in accordance with state law, or the date that the partnership agreement was effective. Further factors, of course must be considered in this case. We do not know the effective date of the agreement. In addition, it is apparent that the first Certificate of Limited Partnership formed a "shell" or "dummy" limited partnership because the filed certificate listed a nominal limited partner in advance of actually selling partnership interests.

In summary, we believe that a facts and circumstances approach should be applied to the determination of a partnership's formation date for purposes of determining when its taxable year began. We are convinced that this approach, when applied to the facts of the instant case, results in a determination that the partnership was formed subsequent to September 3, 1982,

A. Formation Date

We agree with your conclusion that the facts in this case do not support an argument that a de facto partnership existed prior to September 4, 1982, In Sparks v. Commissioner, 87 T.C. 1279(1986), in which the issue was the formation date of a partnership, the critical factor in the Tax Court's analysis was the clear intent, as provided in several documents, that the partnership would be formed only upon the completion of the offering. The court noted that the partnership agreement specified that the respective interests of the partners would vest only upon the completion of the offering, and that the subscription funds were held in escrow until December 31, 1982, when they were transferred to an operating account. The court found the documents reflected the intent of the parties to form the partnership in December. It was only at the closing of the offering that the parties acquired their respective capital interests in the partnership.

The Tax Court rejected the petitioners' argument that the general partner's actions in incurring expenses, commencing negotiations of business agreements on behalf of the partnership, and receiving subscriptions created a de facto partnership prior to September 4, 1982. Reiterating the fact that the prospective limited partners were entitled to a refund of their contributions if the offering were aborted, the court observed that neither the solicitation of capital from prospective partners, nor the general partner's commencement of negotiations with third parties on behalf of the partnership to be formed, create a partnership. The court indicated that the expenses incurred, subscriptions obtained and negotiations conducted all represent pre-operating activities, and no capital interest vested in any partner prior to the closing of the offering.

Regardless of the existence of activities by the general partner in this case prior to September 4, 1982 we agree that the fact that no subscriptions had been purchased prior to that date makes the instant case weaker than Sparks on the issue of a de facto partnership.

The facts in this case indicate a formation date subsequent to the TEFRA effective date of September 3, 1982. For example, the private placement memorandum is dated [redacted]; the first partnership interest was sold [redacted]; bank accounts were opened [redacted] and a Certificate of Limited Partnership effective [redacted] was filed [redacted]. The certificate indicates that the partnership term shall be from the effective date of the certificate. In addition, the partnership asset was acquired on [redacted]. A credible argument can be made that the partnership was formed by [redacted].

The Certificate of Limited Partnership is the only significant document which includes the parties intent on formation date, i.e. upon its effective date. By the effective date of the filed certificate, [redacted], the partnership consisted of a general partner and a dummy partner, who never purchased a partnership interest. The original limited partner was merely a straw man designated to fulfill state law requirements. Thus we believe the effective date of the original certificate formed merely a shell partnership. Subsequently partnership interests were sold, and bank accounts were opened. The offering was to terminate at the earlier of the purchase of [redacted] interests or [redacted]. By the effective date of the Amended Certificate of Limited Partnership, [redacted], [redacted] of the [redacted] partnership interests had been sold. In addition, the offering was obviously extended rather than terminated, as the partnership documents allowed, because the remainder of the [redacted] total units were sold by [redacted]. The partnership asset was acquired on [redacted].

We note that in L and B Land Lease Group v. Commissioner, T.C.M. 1987-264, the court in determining formation date at least considered the factor of whether business was conducted prior to the date upon which the court held the partnership was formed. Also, in Frazell v. Commissioner, 88 T.C. No. 78 (May 27, 1987) the court was unable to establish an exact date as the formation date. Rather, based on the fact that the partnership was fully subscribed by the end of 1982, the court also looked to the general partner's activities. The general partner entered lease agreements to acquire the business assets and prepaid the rent. In effect, the court viewed the commencement of business as unequivocally implementing the intent to form a partnership.

Pursuant to Treas. Reg. § 1.709-2(c) regarding the treatment of partnership organization costs, the acquisition of operating assets which are necessary to the type of business contemplated may constitute beginning business. In summary, the Tax Court in determining formation date has considered the factor of business commencement date which in this case can be argued as concurrent with the asset acquisition on [redacted].

In the instant case, [redacted] partnership interests remained to be sold as of [redacted] and arguably none of the interests vested until all [redacted] interests were sold. Yet, the fact that the offering was extended rather than terminated along with the commencement of business (acquisition of assets) provides reasonable support for the position that formation occurred by [redacted] as evidenced by the formation intent contained in the Amended Certificate of Limited Partnership. The Amended Certificate's effective date was [redacted], and it was recorded on [redacted], at which time all [redacted] interests had vested.

Notwithstanding the facts that business was conducted in [redacted], that the original intent was for the offering to close and formation to take place by [redacted] and that the Amended Certificate of Limited Partnership which was recorded after all interests vested had an effective date of [redacted], we believe the partnership interests were revocable until all [redacted] interests were sold, and this did not occur until [redacted]. Therefore, the partnership was not formed until [redacted].

The private placement memorandum stated that the partnership will only be funded upon the receipt and acceptance by the general partner of all [redacted] subscriptions. If subscriptions for all interests were not received or accepted on or before [redacted] (sic) unless extended by the general partner, the offering would terminate, and all funds would be refunded with interest. The Subscription agreement provided that if less than [redacted] interests were sold, the general partner "shall terminate the offering and return all subscription funds."

Both L and B Land and Sparks analyzed the closing of an offering and the vesting of interests with respect to when a partnership was formed. In L and B Land a review of all the facts led to the conclusion that the partners intended that L and B be formed as of the date on which the last partnership unit was sold, but not later than October 31, 1982. The offering memorandum, for example, stated the offering would close when all 99 units were purchased but not later than 10-31-82. The court also pointed out that it is not the irrevocability of subscriptions (there was a minimum subscription amount) which is controlling for determining formation date but rather the intent of the parties. The last unit was sold on September 13, 1982, and in light of all relevant factors, the court concluded that the parties intended to form L and B on September 13, 1982.

In Sparks the offering was scheduled to close on June 1, 1982 but was extended until December of 1982. The offering could be terminated if all 80 units offered were not subscribed by the closing date. Upon termination, all funds and documents were returnable to the subscribers. The partnership agreement and offering memorandum stated the partnership commenced upon closing of the offering, and the agreement also provided that the interests of the partners vested upon the closing of the offering. The offering closed in December 1982, and the court noted that the documents reflected the intent of the parties to form the partnership in December, 1982.

A partnership is formed when the first parties to the venture acquire their respective capital interests in the partnership. Sparks v. Commissioner 87 T.C. 1279 (1986). See also Hensel Phelps Construction Co. v. Commissioner, 74 T.C. 939,948-49 (1980), aff'd 703 F.2d 485 (10th Cir. 1983). In Sparks the interests of the partners did not vest prior to the closing of the offering because until such time the general partner could terminate the offering and return the funds to the investors. Similarly, in the instant case, if all [redacted] units were not sold, the offering would terminate and funds would be returned to investors. Because the [redacted]th unit was sold on [redacted], we believe that the partners' capital interests vested, and the partnership was formed on that date.

Notwithstanding our belief that the most reasonable position is that the partnership formed in [redacted] when the offering closed, the partnership would be subject to the TEFRA partnership audit and litigation provisions for taxable year [redacted]. The partnership filed a partnership return for [redacted] and section 6233(a) provides that if a partnership return is filed by an entity for a taxable year but it is determined that the entity is not a partnership for such year, the TEFRA partnership provisions are extended to such entity for such year. See Frazell v. Commissioner, 88 T.C. No. 78 (May 27, 1987).

B. Small Partnership Exception

We have several comments on the issue of whether the § 6231(a)(1)(B) exception for small partnerships would apply to exempt [redacted] from the TEFRA procedures for taxable year [redacted]. You point out that at the time of the filing of the Certificate of Limited Partnership on [redacted], the partnership contained two partners. By the end of [redacted], the partnership had more than ten partners which made the small partnership exception inapplicable, but you question whether we could argue that the partnership interests which were sold subsequent to the first Certificate did not take effect until the amended Certificate of Limited Partnership was filed in [redacted].

We note at the outset that this argument is weakened by the fact that the amended certificate, though signed and filed in [redacted], was dated [redacted] and had a [redacted] effective date. But more importantly, in order for the small partnership exception to the TEFRA rules to apply in [redacted], a partnership or an entity to which TEFRA applied would have to exist. For [redacted], either the partnership was formed in [redacted] or if formed in [redacted], TEFRA rules would apply because of section 6233 and the filing of a [redacted] partnership return.

From this basic premise we note that the facts indicate that [redacted] partnership units had been sold by [redacted]. If we assume that the partnership was formed in [redacted], the small partnership exception is not applicable. The subscribed interests would vest upon acceptance by the general partner. For federal tax purposes, we would not consider the vesting of partnership interests contingent upon the filing of an amended Certificate of Limited Partnership. In Frazell, supra, the court pointed out the existence or non-existence of a partnership under state law or a properly formed limited partnership under state law is not determinative for federal tax purposes. Although the filing of a Certificate of Limited Partnership is a factor to be evaluated in determining formation date it is not a sole determinative factor with respect to the vesting of partnership interests. If we assume that the TEFRA rules apply in [redacted] pursuant to section 6233, the fact that more than ten partnership interests were sold by the end of the year would, of course, also make the small partnership exception inapplicable.

C. Estoppel

With respect to your discussion of various possible estoppel arguments, we agree with your conclusion that such arguments would be unsuccessful. First, with respect to the statements on the tax return that business started [redacted] and the partnership was actively operated for 6 months, we doubt that the Service can prevail on an estoppel argument based solely on statements on the tax return. Furthermore, in this case it appears that more careful consideration of the available facts would have raised reasonable doubts about the representations on the return.

The Service may never rely completely on information provided on the partnership return when making determinations relative to TEFRA partnership proceedings. In Century Data Systems, Inc. v. Commissioner, 86 T.C. 157 (1986), the court took a narrow view of misrepresentation on tax returns. The court placed the responsibility on the Service to determine the correct taxable year and stated that there is a duty to investigate to determine whether the return is erroneous in any respect. "As long as the necessary books and records are available to the examining agent, he alone is responsible for developing whatever data is necessary for the proper computation of tax liability." Id. at 170. It is our opinion that the Service probably would not have an estoppel argument with regard to a TEFRA classification issue absent willful misrepresentation.

Further investigation is always necessary whenever there is a reasonable basis to question any representation. Any inconsistencies, either within the return or between the return and other known facts, or any unusual representation would warrant further investigation. In addition, at any point that unusual or questionable facts emerge, the necessity for further investigation of any previously accepted representations should be carefully evaluated.

With respect to your discussion of the claimed deductions and credits as if the partnership was in existence on [redacted], it was, of course, the Commissioner's duty to determine whether such deductions or credits were erroneous. The agent questioned the general partner about the beginning date of partnership activity but failed to clarify the ambiguous answer. The Service could have determined that the partnership did not own its primary asset by [redacted] and therefore could not amortize start-up costs beginning [redacted]. As you note section 709(b)(1) provides that start-up costs are amortizable beginning with the month in which the partnership begins business, and Treas. Reg. § 1.709-2(c) relates this date to the acquisition of assets.

Finally, with respect to the general partner's answer to the examiner's question (Information Document Request 3, page A-24) "Why was the tax year stated as begining on [redacted] when the partnership activity appears to have begun [redacted]?", the general partner's answer demonstrated a need for further investigation and raised many questions regarding formation date of the partnership. You indicate that the agent was not focusing on the TEFRA classification issue, which further demonstrates a default in the duty to investigate.

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